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SUBJECT: IMF ANTICIPATES STRONG MACRO-ECONOMIC PERFORMANCE

¶1. (SBU) Summary: The IMF expects Laos's economy to continue to grow at a strong 8 percent annual rate, driven by mineral and electricity exports. Inflation is relatively low at 5 percent, but the IMF is concerned that the government is expanding commercial credit too quickly raising the specter of a new round of non-performing loans. The long-term challenge for the government will be to encourage more broadly based growth that creates more employment opportunities for the vast majority of Lao who still depend on subsistence agriculture for their livelihoods. End summary.

¶2. (SBU) An IMF team briefed selected donors on the outcome of their Article IV consultation with Lao government on May 13. The team leader reported that he had been impressed by the candid performance assessments he had received from Minister of Finance Somdy Douangdy, Governor of the Central Bank Phouphet Khamphounvang, and other Lao senior officials. Overall, his team judged Lao macro-economic management as good. The Lao had achieved 8 percent growth in 2007 and were on track for a similar growth rate in 2008. Reserves had doubled in the past eighteen months.

¶3. (SBU) Inflation is the IMF and government's principal concern. The core rate of inflation is near 5 percent, largely driven by cost-pull factors -- principally rising fuel and food costs -- while the year-to-year inflation rate in April was 9 percent. The IMF was interested in knowing what measures the government was considering to limit the impact of fuel price hikes. Although unwilling to provide details in advance of a government announcement, the IMF team leader indicated that the measures the Lao government was considering to curb fuel prices were "temporary, targeted at the most vulnerable and the least market-altering."

¶4. (SBU) The team also raised its concerns over the inflationary impact of a sharp increase in commercial credit. The team stated that commercial credit had grown 42 percent year-to-year; last year credit growth was negative as the focus was on the restructuring of the state-owned banks and their burden of non-performing loans (NPLs). Although Laos's economy is heavily dollarized, the government has allowed the "Kip" money supply to grow 75 percent.

¶5. (SBU) The IMF team expressed worry not only over the quantity of the credit expansion, but also the quality, and said they had cautioned the government against creating a new round of NPLs. The Lao, the IMF said, had made effective use of exchange rate policy (linking the Kip to the Thai Baht), but were not as skilled in managing monetary policy or liquidity. In a rare unguarded comment, an IMF team member suggested that the government was using credit extended by state-owned banks -- some technically insolvent -- to "pump prime" the economy in order to meet ambitious growth targets. The IMF team added that they had encouraged the Lao Central Bank to step up its regulatory capacities and offered technical assistance.

¶6. (SBU) On the fiscal side, the budget outlook was good. Revenues from taxes on mineral imports were better than expected, but so too were other tax revenues reflecting improved administration of the tax collection system. Expenditures were consistent with the budget provisions, and the IMF saw no indication of any significant off-budget or unreported budgetary expenditures. Looking ahead, the IMF warned the government against allowing wage increases now under consideration to crowd out other recurrent spending in essential areas such as education and health.

¶7. (SBU) The IMF team, in their responses to questions, acknowledged donor concerns that the government may not use its revenue windfalls from the mining sector to address poverty alleviation and strengthen essential human welfare services. They said they had briefed the government in some detail regarding the best practices for a "state accumulation fund" intended to use revenues from resource exports to meet long-term development needs. The government is considering one, but did not offer the IMF any details regarding their plans.

¶8. (SBU) The team also mentioned their concerns regarding the unreliability of some statistics. For example, balance of payments data do not fully capture -- and may deliberately under-report -- remittances from Lao working in Thailand and elsewhere overseas from relatives. The Lao also were unwilling to discuss or estimate the parallel, informal or illegal economy.

¶9. (SBU) Comment: The fundamental question for the Lao economy remains the quality of growth. The government faces

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a significant challenge in translating recent and future surges in revenues and GDP growth driven by the resource sector into more broadly based growth that generates significant employment. The good news, according to the IMF, is that the Lao planning authorities seem to have a strong appreciation of the need to direct government resources towards infrastructure and human resource development necessary to stimulate growth in sectors such as tourism, plantation agriculture and light manufacturing. The rate of new flows of foreign direct investment and official development assistance appears, in the IMF's judgment, sufficient to finance these capital requirements and sustain current growth rates for at least several years.  
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